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SUBJECT: MONTENEGRO WEATHERING THE GLOBAL FINANCIAL STORM

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SUMMARY

¶1. (SBU) Montenegro's banks have been fairly insulated from the global financial crisis by their conservative banking practices. Foreign banks face a rockier future, but in general the small size of the sector and absence of investment banks has provided a cushion. In addition, the government has put in place unlimited guarantees on deposits and now can serve as guarantor of inter-banking credits, or can offer loans for banks to retain liquidity. It can also, if necessary, inject additional capital to shore up balance sheets. The greatest risk to the Montenegrin economy lies in the longer-term effects of the crisis, particularly as it is dependent on foreign direct investment to support continued economic growth. Furthermore, the real estate and tourism sectors - two key sectors in the Montenegrin economy - could be affected by slackening global demand. Local experts, however, note better than expected GDP growth in 2008. While seven percent was projected, there has been eight percent growth in the first nine months of the year already. The overall the Montenegrin economy appears likely to weather the crisis, at least in the near term. End summary.

New Law Adopted to Protect Financial Sector

¶2. (SBU) The new Banking Sector Protection Law was adopted by the parliament on October 22. According to Finance Minister Igor Luksic, the law was designed as preventative measure against the global financial crisis as he believes that the banks in Montenegro are currently stable and secure. Luksic said that the law guarantees all deposits of citizens and companies. According to the new law, the state also would guarantee inter-bank credits and will be able to provide loans for banks in order to preserve their liquidity, as well as to conduct capital increases for certain banks. Interestingly, Luksic claims that all deposits will be guaranteed, with no FDIC-type limit. The GoM does have access to roughly half a billion euros, which many experts speculate would be enough to keep the banking system afloat in any foreseeable crisis, but we assess (as do our European colleagues) that no real thought has gone into the

potential long-term impact on the economy if Montenegrin banks were to suffer from a serious liquidity crisis and have to tap into this guarantee. With the adoption of the law safeguards are in place, but Montenegrin officials continue to assert that the banking system is quite healthy and that there will be no need for any serious intervention.

¶3. (SBU) Montenegro uses the Euro as its official currency (since 2002), but does not belong to the Euro zone. Use of the Euro defines the role of the Central Bank; since its authority is limited, it focuses primarily on controlling the banking system, and maintenance of the payment system. It acts as the state fiscal agent, monitors monetary policy, and acts as a control on the banking sector. The Central Bank adopted a set of measures late last year designed to slow down the credit growth and contribute to the transparency of the banking sector. It prevented local banks from extending riskier credit, which may be another reason that the sector seems to be weathering the storm.

Current Crisis Opens Old Wounds

¶3. (U) In 1990 Dafiment bank was established in Yugoslavia. The bank offered monthly interest of up to 15 percent on deposits in dollars or marks. At the time, average monthly salaries equated to roughly twenty dollars a month (Yugoslavia still used Dinars), so with USD 1,000 in the bank, people could earn USD 150 a month in interest. This money made a significant difference in everyday lives when exchanged for Dinars at the spiraling black-market rate, so a significant amount of teh population jumped at the Dafiment bank offer and moved their entire savings to the bank. In 1993 Dafiment went bankrupt and

those who had invested their life savings lost everything. These people are still waiting for their money to be refunded by the Governments in Belgrade and Podgorica. (Note: Though Dafiment was a private bank, because the effects of its collapse were so dramatic, the Government of Montenegro has allocated 20 million Euros to return the original deposit amounts to Montenegrin citizens, which will be distributed over the next ten years. End note.) For years following the Dafiment collapse, the banking sector saw very few deposits as people no longer trusted the banking system.

4 (U) During the last few years, Montenegro has experienced a stabilization of the banking sector, along with a gradual development of the capital market, thereby restoring consumer confidence in banks. Foreign banks entered the Montenegrin market during the privatization of the sector (completed in 2006), competition has increased, electronic banking has been introduced, savings have increased, and customer credits have been established. As one banker explained to local press, the influence of the global financial crisis will be felt through the increased unease among clients, especially those who had bad experiences with their bank deposits in the 1990s.

Business as Usual, While Preparing for the Worst

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¶5. (SBU) Representatives of Montenegrin banks have claimed publicly that the banks are working normally, though the global financial crisis has influenced the growth of reference interest rates and accessibility for long-term sources of financing. Some bank representatives, however, have told us privately that they

are somewhat concerned about developments over the past month. They all assess that the worst outcome would be a confidence scare and subsequent run on the banks. To this end, they all agree the GoM deposit guarantee measure has served as a positive indicator to citizens that everything is okay and should boost confidence in sector. One bank CEO, however, opined that GoM strategy was just a time saver. He went on to say that the GoM is just crossing their fingers the global crisis will start to turn around before Montenegro becomes more involved.

Looming Liquidity Crisis?

¶6. (SBU) One bank CEO told us that while the country is not yet seeing a run on banks, there has been an increase in deposit outflows. To quote another banker, "more and more people are hiding money under beds and in safety deposit boxes." Two banks already have reportedly slipped into their mandatory reserves and another bank worries that it could be there within weeks. The sector, however, has remained quiet enough about the looming liquidity problem that it appears to be holding steady for now. We were beginning to see unusual lines at a handful of banks last week, but this week all banks seem to be operating normally. Senior GoM officials also have been working to maintain confidence in the markets with President Filip Vujanovic, Prime Minister Milo Djukanovic, and Deputy Prime Minister for Economic Policy Vujica Lazovic all joining Luksic in speaking out publicly to reassure the populace. And in one positive note, term deposits (one year CDs are most common) have remained steady, indicating a reasonable amount of trust in the long-term viability of the sector.

Interest Rates Up, No One Lending

¶7. (SBU) The absence of a true investment banking sector in Montenegro and the fact that all approved credits to companies and citizens are backed by property as collateral, a crisis of the nature seen in the U.S. and Western Europe is extremely unlikely in Montenegro. The bigger concern is the increasing inability for citizens or companies to get credit. Most local banks increased interest rates in early October and experts say that it is already impossible to get a loan at any rate. The lack of trust shown in global financial markets during the last month, as well as reported losses of large banks, have influenced the growth of reference interest rates and hurt the accessibility of long-term financing sources in the form of inter-banking credit lines on capital markets. Because of this, sources of financing -- especially those connected with the international capital markets -- are much less accessible and thus much more expensive.

¶8. (SBU) In a country reliant on a burgeoning entrepreneurial class and a steady flow of foreign investment for its economic

growth, the high interest rates and a shrinking credit are significant concern. This week, PM Djukanovic, viewed as extremely focused on growing the economy and increasing foreign investment, finally spoke out about the crisis. According to the PM, although it will be increasingly difficult given the situation facing many global investors, the most important task of the GoM during the next year will be to create conditions for further development of investments. His words should shore up confidence in the financial sector.

Prva Banka: First to Show Signs of Collapse

¶8. (SBU) On October 22 the Central Bank implemented measures to prevent potential problems in Prva Banka (First Bank), which was starting to show signs of a liquidity crisis. A temporary halt has been put on Prva's asset increases, except in cases which could strengthen the bank's liquidity (i.e. collecting deposits), and currently Prva is prohibited from trading on the capital market as well. Experts assess that the bank's liquidity problem is a result of rapid and uncontrolled growth of deposits, credits, and investments. (Note: Prva Banka's assets in June 2006 were 29 million Euros and grew to 546 million in 2008, leaving many to speculate how one bank in a small country could grow so much, so fast. End note.) It is expected that the measures introduced by the Central Bank will stymie short-term consequences for customers, but only partnership with a foreign investor will solve the bank's problems in the long term. Prva, however, had been showing signs of trouble for over a year now according to experts, so a serious crisis there -- though that appears to have been averted for now -- would not signal a sector-wide crisis that the failure of another bank might.

COMMENT

¶9. (SBU) Local experts and foreign diplomats in Podgorica surmise that Montenegro may well avoid being dragged down by the global crisis. As Deputy PM Lazovic told local press, "the country's GDP growth indicates an upward trend in the Montenegrin economy at a time when many countries are reviewing their growth projections." There is some nervousness about a real estate bubble here which also could be at risk or that the tourism sector - on which the economy is so dependant - could suffer from a global downturn. However, with prominent political leaders continuing to reassure the public, a full-blown crisis of confidence in the sector should be avoidable.
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